IN THE SUPREME COURT OF THE UNITED STATES

October Term 1977

No. 77-995

HARRY GORDON and
GERALDINE GORDON,

Petitioners,

vs.

COMMISSIONER OF
INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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VOLUME I
of Two Volumes

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TO THE HONORABLE CHIEF JUSTICE AND
ASSOCIATE JUSTICES OF THE SUPREME
COURT OF THE UNITED STATES:

HARRY GORDON and GERALDINE GORDON, the Petitioners herein, pray that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Ninth Circuit, entered in the above-entitled case on August 26, 1977.

OPINIONS BELOW

The Opinion of the United States Court of Appeals is not yet reported other than in the tax service at 40 A.F.T.R.2d 77-5727; it is printed in Appendix A hereto. The Judgment of the United States Tax Court is reported at 63 T.C. 51 (the issue herein is discussed at pp. 77, 78). The United States Tax Court also filed a Supplemental Opinion reported at 63 T.C. 501, dealing with the issue herein. Because the Opinions of the United States Tax Court are voluminous, they are separately presented as Appendix C and Appendix D.

JURISDICTION

The Judgment of the United States Court of Appeals for the Ninth Circuit was entered on August 26, 1977. A timely Petition for Rehearing was denied on October 13, 1977. (Appendix B) The jurisdiction of the Supreme Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the wagering excise tax imposed under 26 U.S.C. 4401 may be accrued by a taxpayer conducting a legalized gambling business to offset the income generated by wagers which are not reflected in the income tax return, during the

identical year in which the income is to be reported? A more generalized statement of the issue is whether an accrual basis taxpayer may accrue a deduction for an excise tax placed indirectly in dispute by an attack against assertion of a related income item, owed to the same soverign, in order to correctly correlate items of income and expense arising out of the same transaction in the same taxable year.

STATUTES INVOLVED

26 U.S.C. 461(a) GENERAL RULE. - The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

26 U.S.C. 4401. IMPOSITION OF TAX.
(a) WAGERS. - There shall be imposed on wagers, as defined in section 4421, an excise tax equal to 10 percent of the amount thereof.

STATEMENT OF THE CASE

Deficiencies were proposed for assessment against HARRY and GERALDINE GORDON for the calendar year 1967. A timely petition to the United States Tax Court was filed by the taxpayers, pursuant to 26 U.S.C. 6213, 6214 (granting

jurisdiction to that Court). In response to the question raised herein, the trial Court recognized the nature of the wagering excise tax, and stated:

> "The wagering excise tax is a necessary cost of taking a wager and a necessary offset to wagering income. . . . Under Section 461(a) a deduction is to be claimed for 'the proper taxable year under the method of accounting used.' In a situation such as this, where a deduction is a direct function of the income, in one-to-one correspondence with it, proper matching of income and expense require that both are taken in the same year. To do otherwise would be as improper as to require a taxpayer who denied making a sale to accrue the sales income in one year and his cost of sales in the latter year of resolution of the dispute. The wagering excise tax is part of the cost of taking the wager, and belongs to the same taxable year as that of the wager."

The United States Court of Appeals for the Ninth Circuit disagreed with this conclusion of the trial Court, and reversed. A dissent was lodged by one member of the panel on this issue.

HARRY GORDON was the majority partner in a partnership known as the Derby Turf Club ("Derby"), which operated a legalized bookmaking establishment in Las Vegas, Nevada. During the calendar year 1967, the Derby was on the accrual method of accounting. Wagers were taken by employees of the Derby (not the petitioners herein),

which were held to be taxable to the Derby, but were not reported on its federal income tax return for the year 1967. The amount of the additional income, as proposed by the Commissioner, was placed in dispute by the taxpayers through their petition to the United States Tax Court, and during trial of the case, the initial computation was admitted to be overstated by counsel for the Government. The United States Tax Court ultimately determined the amount of the omitted income, which determination was affirmed by the Appellate Court. The trial Court also determined that the taxpayers could accrue the wagering excise tax attributable to the additional wagering receipts. The Court of Appeals reversed this finding in a two to one opinion.

REASONS FOR GRANTING WRIT

A conflict has recently developed between the Court of Appeals for the Ninth Circuit (this case) and the Court of Claims (Hollingsworth, Jr. v. United States, Trial Div. Opinion reported at 76-2 U.S.T.C. 9750, aff'd. by Court per curiam with modification of two footnoes, 12/14/77) on the issue of accrual of expenses related to unreported income subsequently ascertained. In our opinion, the Court of Claims rejected the reasoning of the Ninth Circuit and adopted the reasoning of the Tax Court in this case by stating in revised Fn. 13:

> "The Tax Court Opinion, modifying 63 T.C. 51 (1974), was appealed by the Government to the Ninth Circuit Court of Appeals on the ground that the continuing

litigation concerning the amount of unreported wagering income prevented the accrual of the excise tax expenses associated with that income. The Ninth Circuit accepted the Government's argument and reversed the Tax Court. (Citation) We note that the Ninth Circuit was not faced with the specific issue involved in the present case, that is whether the concealment of transactions is a 'contest' for the purpose of the 'all events' test, but have, nonetheless, weighed the opinion of the Ninth Circuit carefully. We believe that, in the circumstances of the present case, the trial Judges' reliance on the result reached and the reasoning employed by the Tax Court was not misplaced since it appears that the Tax Court decision was more in consonance with our rationale in Dravo and with relevant authorities, regulations and rulings." (Emphasis added.)

We have been advised by counsel for Hollingsworth that the Government distributed to the Court copies of the Ninth Circuit opinion in Gordon during oral argument on review of the trial Judge's opinion.

The accrual method of accounting is used by virtually every substantial business in the country - its use is compulsory if the taxpayer has any inventory. The Courts have strived in recent years to articulate the general principles governing use of the accrual method, most often successfully, but sometimes creating more questions than they resolve. The Tax Court opinion, by an

experienced tax practitioner and Tax Court Judge, shed light in explaining the accrual method; the Appellant Court's short and conclusionary statement creates substantial confusion in that it strays from the emerging law set forth by this Court and the Circuit Courts throughout the country. It is of the utmost import that this Court clarify the law in this area affecting all major business so that there is certainty rather than fuel for litigation.

As a general rule, a taxpayer using the accrual method of accounting will deduct its expenses, including taxes, in the year in which all the events have occurred which determine the fact of the liability and the amount thereof with reasonable accuracy. E.g., United States v. Anderson (1926) 269 U.S. 422; Crescent Wharf and Warehouse Co. v. Commissioner (9th Cir. 1975) 518 F.2d 772; Treasury Regulations on Income Tax (1954 Code) §1.461-1(a)(2). It is, accordingly, well settled that an accrual basis taxpayer will deduct his liability for taxes in the year in which the events fix his tax liability, notwithstanding that the taxes are not paid, nor the tax return filed, until a later year. United States v. Anderson, supra.

The wagering excise tax constitutes a charge against the wager at the time the wager is placed. Treas. Reg. §44.4401-3 reads in part:

> "The tax attaches when (a) a person engaged in the business of accepting wagers with respect to a sports event or a contest, or (b) a person who operates a wagering pool or lottery for profit, accepts the wager or contribution from a bettor. In the case of a wager on credit, the tax attaches whether

> or not the amount of the wager is actually collected from the bettor. . . ."
> (Emphasis added.)

By reason of the last sentence, the tax becomes an absolute liability whether the income from the wager is subject to taxation or not.

The objective of the accrual method of accounting is to match income and directly related expense, to the extent possible. This was done with the accrual of workmen's compensation insurance (Crescent Wharf & Warehouse Company v. Commissioner, supra, 518 F.2d 772), expenses related to sold but unshipped goods (Pacific Grape Products v. Commissioner, 9th Cir. 1955, 219 F.2d 862), commissions on the sale of furniture (W. S. Badcock Corp. v. Commissioner, 5th Cir. 1974, 491 F.2d 226), commissions on the sale of title insurance policies (Lawyers Title Guaranty Fund v. United States, 5th Cir. 1975, 508 F.2d 1), and the commissions of life insurance salesmen (North American Life and Casualty Co. v. Commissioner, 8th Cir. 1975, 533 P.2d 1046).

The Commissioner traditionally argues that income and related expense should be coordinated, and the Courts traditionally agree. In Commissioner v. Standard Life & Accident Ins. Co. (1977) ___ U.S. ___, 97 S.Ct. 2523, 2529, this Court stated:

> "In a sense the case presents a question of timing. Respondent claims the right to treat unpaid premiums as creating reserves, and therefore a tax deduction, in one year, but wishes not to recognize the

unfavorable tax consequences of increased 'assets' and 'premium income' until the year in which the premiums are actually paid. As the Government forcefully argues, the respondent's position lacks symmetry and the lack thereof redounds entirely to its benefit."

The Courts have consistently held that where uncollected income is accrued, commissions payable from that income, contingent only on collection of the sales price, may likewise be accrued. W. S. Badcock Corp. v. Commissioner, supra; Lawyers Title Guaranty Fund v. United States, supra; Great Commonwealth Life Insurance Co. v. United States (5th Cir. 1974) 491 F.2d 109; Franklin Life Insurance Co. v. United States (7th Cir. 1968) 399 F.2d 757, c.d. 393 U.S. 1118; Federal Life Insurance Co. v. United States (7th Cir. 1975) 527 F.2d 1096.

In North American Life & Casualty Co. v. Commissioner (8th Cir. 1976) 533 F.2d 1046, the Court approved the rationale of the Tax Court (63 T.C. 373):

> "Upon receipt of premiums, it is clear that a liability to pay commissions arises. Assumption of receipt of premiums necessarily requires recognition of the concomitant liabilities, for the petitioner cannot receive premiums without incurring corresponding commission expenses. Both the accrual of income and deduction of commissions are subject to the same contingency, that is, the receipt of the premiums.

> Respondent [the Commissioner] cannot ignore the contingency in requiring accrual of income yet assert such contingency in determining the accrual of related deductions." Emphasis per Appellate Court, 533 F.2d, at 1050.

The Court added: "Once a taxpayer accrues all gross income that has been deferred, consistency would mandate that other directly related cost items that can be determined with reasonable accuracy should be accrued on the other side of the ledger." (Emphasis added) 533 F.2d, at 1050-1051.

The import of this case goes well beyond the accrual of wagering excise taxes, but rather relates to the accrual of any type of expense that is directly related to an item of income, such as commissions, sales expenses, etc. The effect of the Opinion is to tax in 1967, $269.319.04 of accrued income, but to postpone deduction of the offsetting wagering excise tax of $181,156.01, which tax follows the income as night follows day. Neither the income nor the excise tax were determined until the Court issued its ruling. The legal test for each accrual is identical - the "all events" test. Why, in any case, should the income be taxed in one year and the tax deducted in another?

The trial Court, relying upon Treasury Regulations, stated:

> "We agree with petitioner that the Derby is entitled to accrue the wagering tax and, as noted above, have allowed such accrual. 'Under an accrual method of accounting, an expense is deductible for

the taxable year in which all the events have occurred which determine the fact of the liability and the amount thereof can be determined with reasonable accuracy. * * * Where a deduction is properly accrued on the basis of a computation made with reasonable accuracy and the exact amount is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year in which such determination is made.' Section 1.461-1(a)(2), Income Tax Regs. The wagering excise tax accrued as soon as the Derby took a wager; the only question is the amount of unreported wagers the Derby took in 1967. We determine the amount of such wagers in this litigation. On those wagers the excise tax accrued in 1967 and is reflected in our determination. . . .

"The wagering excise tax is a necessary cost of taking a wager and a necessary offset to wagering income. Were there some legitimate question whether the tax attached and were petitioner seeking to avoid its payment with respect to admitted wagers, there would be a dispute within the meaning of the regulation; all the necessary events for resolution of the liability would not have occurred and there would be no accrual. But here, the wagering tax clearly attached to the transaction when it occurred. Despite the attempted concealment of some of the

the transactions, there was never any claim that the tax did not attach to them. To construe the regulation under such circumstances to place the income and the directly correlative expense in different taxable years would be unnecessarily and gratuitously to move away from the objective or proper measurement of income. We see no reason to find that the petitioner's attempted concealment of part of the income, reprehensible though it was, constitutes a license to respondent to force upon the Derby an accounting method which does not properly reflect its income. We do not believe that the Derby may defer accrual of an associated expense clearly due and payable, any more than it can defer accrual of the corresponding gross income, merely because petitioner intended to try to conceal the transactions. We are cited to, and find, no authority holding that attempted concealment of a transaction creates a 'dispute' within the meaning of the regulation, and we decline to so hold."

CONCLUSION

For the foregoing reasons, this Petition for a Writ of Certiorari should be granted.

Respectfully submitted,

BRUCE I. HOCHMAN and
HARVEY D. TACK

Attorneys for Petitioners

APPENDIX A

IN THE

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

HARRY GORDON and GERALDINE GORDON, Petitioners-Appellants-Cross-Appellees, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant.	Nos. 75-2567 and 75-2960 OPINION

On Appeals from the Decision of the United States Tax Court.

Before CUMMINGS,* HUSTEDLER and KENNEDY, Circuit Judges. PER CURIAM:

The petitioners reside in Las Vegas, Nevada, and timely filed their 1967 federal income tax joint return with the district director of Internal Revenue at Reno, Nevada. In this opinion, we refer only to petitioner Harry Gordon because his wife Geraldine is involved only to the extent of the joint return.

*

The Honorable Walter J. Cummings, United States Circuit Judge, Seventh Circuit is sitting by designation.

The Commissioner of Internal Revenue determined a $177,472.60 deficiency plus a $88,736.70 civil fraud penalty as to petitioner's 1967 income tax return. However, the tax court reduced the deficiency to $38,577.60 and refused to approve a fraud penalty. Turning aside assertex Fourth and Fifth Amendment claims, the court also refused to suppress evidence seized pursuant to a search warrant during a raid by the Internal Revenue agents on the Derby Turf Club, a licensed horse-race and sports bookmaking establishment in which petitioner was an 80 per cent partner. With modifications accepted by the Commissioner, the tax court approved his determination of the Derby's unreported net income derived from projections based on wagering tickets seized in the raid. The court applied the profit percentages of the Derby on reported wagers to the amounts of gross wagers, determined by extrapolation, in order to develop gross profit figures for the Derby. Petitioner has appealed from these rulings.

The tax court permitted the Derby to accrue and deduct from 1967 income its liability under 26 U.S.C. § 4401(a) for federal wagering excise taxes due and then unpaid on the additional amount of the 1967 wagers determined in the tax court proceedings. It also held that the Commissioner failed to carry his burden of proving that petitioner's underpayment of income tax was due to fraud. The Government has cross-appealed from these adverse rulings.

The issues are fully developed in the tax court's amended opinion reported at 63 T.C. 51 (1974) and 63 T.C. 501 (1975). Except in one

respect (discussed infra), we adopt that opinion as our own. We need only briefly comment on these issues in our opinion here.

After the tax court rendered its opinion, the Supreme Court decided Andresen v. Maryland, 427 U.S. 463, which virtually destroys petitioner's claim that the evidence upon which the Commissioner's deficiency determination was based should have been suppressed because it was obtained in violation of the Fourth Amendment and which, as petitioner concedes, entirely defeats his Fifth Amendment claim. To the extent that petitioner's Fourth Amendment suppression contentions ~~is~~/are not answered in Andresen, the tax court satisfactorily demonstrated that the warrant was not overbroad either in detailing the place to be searched or the items to be seized, and that the raiding party did not seize items which the warrant did not authorize them to seize (63 T.C. at 63-69).

In order to estimate the 1967 gross receipts of the Derby, the Commissioner extrapolated the amount of unreported wagers from the day of the raid over the preceding nine months and added that figure to the wagers the Derby had reported for the year. Petitioner attacks this methodology as arbitrary and capricious. However, a somewhat similar extrapolation of wagering data was used to assess wagering taxes in United States v. Janis, 428 U.S. 433, 437, and to assess income taxes in Gerado v. Commissioner, 552 F.2d 549 (3rd Cir.

1977).[1/] In light of the propriety of similar methodologies for generating the amount of unreported wager income by extrapolation and upon our study of the specific methodology used by the tax court here, we hold that petitioner has not made the required showing that the tax court's factual findings were clearly erroneous. Paxton v. Commissioner, 520 F.2d 923, 925 (9th Cir. 1975), certiorari denied, 423 U.S. 1016.

The Derby was on an accrual method of accounting. In its opinion, the tax court does not satisfactorily explain why petitioner was permitted to accrue the 10% wagering tax imposed under 26 U.S.C. § 4401(a) and deduct it as an ordinary and necessary business expense under 26 U.S.C. § 162 in 1967. These excise taxes were paid under protest after the tax court's March 14, 1975, decision thatthere was a deficiency in income tax for 1967 in the amount of $38,577.60. As petitioner has advised us in his reply brief (at p. 5), he intended to file a refund claim if we had reduced the tax court's computation of unreported gross wagers

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1/ See also Mitchell v. Commissioner, 416 F.2d 10, 102-103 (7th Cir. 1969), certiorari denied, 396 U.S. 1060; Hamilton v. United States, 309 F. Supp. 468, 472-473 (S.D. N.Y. 1969), affirmed, 429 F.2d 427 (2d Cir. 1970), certiorari denied, 401 U.S. 913; Mersel v. United States, 67-2 U.S. Tax Cas. para. 15,756 (S.D. Fla. 1967), affirmed (except as to delinquency penalties), 420 F.2d 517 (5th Cir. 1970).

accepted by the Derby. Since the amount of petitioner's liability for the excise tax was not finally accured until our decision passed on the tax court's computation of the Derby's unreported gross wagers, the deduction for the excise taxes cannot be permitted to offset the unreported 1967 income. United States v. Consolidated Edison Co., 366 U.S. 380, 386; Security Mills Co. v. Commissioner, 321 U.S. 281, 284.

We agree with the tax court that the Commissioner did not carry his heavy burden of proving petitioner's fraudulent conduct by clear and convincing evidence. Especially in an area involving credibility findings, the tax court's conclusion should not be upset absent a patent abuse of discretion. Since the Commissioner fails to make out such an abuse, a civil fraud penalty under 26 U.S.C. § 6653(b) may not be imposed.

The decision of the tax court is reversed and remanded with respect to allowing accrual and 1967 income deduction of additional excise taxes on the unreported wagers of $756,937.60 on the Derby's horse-book operation and of $1,054,622.54 on its sport-book operation for the first nine months of 1967. In all other respects the decision is affirmed.

GORDON v. COMMISSIONER OF INTERNAL REVENUE,
Nos. 75-2567 and 75-2960

KENNEDY, Circuit Judge, concurring in part and dissenting in part:

I concur in the majority's opinion except insofar as it states that the wagering excise tax on the receipts in question did not constitute an accrued liability. As to that holding, I respectfully dissent.

The cases cited by the majority, United States v. Consolicated Edison Co., 366 U.S. 380 (1961) and Security Mills Co. v. Commissioner, 321 U.S. 281 (1944) are inapposite to the problem presented here. The Consolidated Edison case addressed the question whether a property tax liability was properly accrued as a deduction in computing federal tax, even though the taxpayer was contesting the property tax in a separate state proceeding. The Security Mills case considered whether the taxpayer could deduct as an accrued liability an agricultural processing tax, notwithstanding that it was contesting the constitutionality of that tax in court proceedings.

In the case before us, the taxpayer has not contested his liability for the excise tax, except in the general sense that he asserts that he is not liable for the income tax. He does so by denying that certain transactions occurred. Once it has been established that the taxpayer earned a certain amount of unreported income for the taxable year in question, neither the Internal Revenue Service

nor the taxpayer would dispute that the excise tax is due. Further, the amount of excise tax is fixed to a certainty by the identical determination that establishes the amount of unreported income. The taxpayer's liability for the excise tax becomes established by reason of this and not some other proceeding. As the Tax Court observed: "In a situation such as this, where a deduction is a direct function of the income, in one-to-one correspondence with it, proper matching of income and expense require that both are taken in the same year." 63 T.C. at 505. I would affirm the tax court's holding allowing the excise tax as a properly accrued deduction for the tax year in question.

/s/ Anthony M. Kennedy
United States Circuit Judge

APPENDIX B

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

HARRY GORDON and GERALDINE GORDON, Petitioners-Appellants-Cross-Appellees, v. COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellee-Cross-Appellant.	)	Nos. 75-2567, 75-2960
	)	ORDER

Before: CUMMINGS,* HUFSTEDLER, and KENNEDY, Circuit Judges.

The panel as constituted in the above case has voted to deny the petition for rehearing. Judges Hufstedler and Kennedy have voted to reject the suggestion for a rehearing en banc. Judge Cummings recommended against en banc reconsideration.

* Honorable Walter J. Cummings, United States Circuit Judge, Seventh Circuit, sitting by designation.

The full court has been advised of the suggestion for an en banc hearing, and no judge of the court has requested a vote on the suggestion for rehearing en banc. Fed. R. App. P. 35(b).

The petition for rehearing is denied and the suggestion for a rehearing en banc is rejected.

10/6/77